

Overview

- How do we calculate:
 - Loan Profitability
 - Deposit Profitability
 - Other Fee Profitability
 - Return on Equity (Putting it all together)
- Engine Resources

Loan Profitability

Includes:

- Interest Income
- Interest Expense & Match Funding
- Non-Interest Expense
- Lines of Credit
- Interest Rate Swaps
- Factoring in Risk
 - Loan Loss Reserve: Adjusting Returns for Expected Loss
 - Capital: Allocating Economic Capital for Unexpected Loss
 - Risk Mitigants: Collateral & Guarantees
 - Loss Given Default and Probability of Default
- Taxes and Tax-Exempt Loans
- Conversion Loans and Rate Locks
- Floating Rate Loan with Floor/Cap

Loan Profitability-Example

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

- \$1MM Commercial Real Estate
- 5 Year Maturity/ Term
- Interest Only
- 5 year term on the funding curve is 2.598% (funding cost)
- 5.375% Interest Rate (Actual/360)
- No Origination Fee

Loan Profitability – Interest Income

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
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Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

Main Inputs:

- Interest Rate (5.375%)
- Interest Rate Basis (Actual/360)
- Origination Fees (\$0)
- Origination Expenses (\$12,487)
- Term (60 months)
- Average Balance (\$1,000,000)

Interest Income is:

- [Initial Interest Rate] x
- [Adjustment for Interest Rate Basis] x
- [Average Balance] +
- [Origination Fees – Origination Expenses, Annualized over the Term]

Specifically in this Example:

- $5.375\% \times (365/360) \times \$1,000,000 + (\$0 - \$12,487) \times (12/60)$
- = \$51,999

Loan Profitability – Interest Income Tax Exempt

	Loans
Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

Main Inputs:

- Interest Rate (4.354%) Bank Qualified Tax Exempt
- Federal Tax Rate 21.0%, 0% State Tax
- Interest Rate Basis (Actual/360)
- Cost of Funds (2.598%)
- Interest Deduction (20%)
- Origination Expenses (\$12,487)

Interest Income is (with 0% State Tax Rate):

- ([Initial Tax Exempt Interest Rate] less
- [Cost of Funds x Interest Deduction x Tax Rate])
divided by (1 – Tax Rate) x [Adjustment for Interest
Rate Basis] x
- [Average Balance] +
- [Origination Fees – Origination Expenses,
Annualized over the Term]

Specifically in this Example:

- $\{(4.354\% - [2.598\% \times 20\% \times 21\%]) / (1 - 21.0\%)\} \times (365/360) \times \$1,000,000 + (\$0 - \$12,487) \times (12/60) = \$51,999$

Loan Profitability – Interest Expense

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

Main Inputs:

- Yield/Funding Curve
- Term Structure¹ (60 months)
- Average Equity (Capital) (\$88,662)²
- Average Balance (\$1,000,000)

Interest Expense is:

- $([\text{Average Balance}]^3 \times$
- $[\text{Funding Curve Value at 60 months}])$

Specifically in this Example:

- $\$1,000,000 \times 2.598\% = \$25,980$

1. Because the example is an Interest Only loan, there is a single repayment at the 60 month term. See the Matched Funding discussion on the following slide.
2. An alternative method is to include capital as part of the funding, in that case the equation becomes $([\text{Average Balance} - \text{Average Equity}] \times [\text{Funding Curve Value at 60 months}])$. But this method is not recommended.
3. Average Balance is weighting the monthly balances over the term of the loan

Loan Profitability Calculations – Match Funding cont'd

(Match Funding is sometimes referred to as “Strip Funding”)

- The table to the right shows the calculation of monthly Interest Expense for a 12 month fully amortizing 5.375% commercial real estate loan.
- The FHLB Curve for the one to twelve month interest rates are based on an actual/360 day basis, this is adjusted by 365/360, see column C.
- Column D shows the principal repayment.
- Column E shows the monthly interest associated with each principal payment.
- Column F is the sum of these payments through the time period, i.e. the costs in Month 1 is sum of Month 1 to Month 12, while Month 6 is the sum of Month 6 to Month 12.

A	B	C	D	E	F
Month	FHLB Curve	FHLB Curve Adjusted	Principal Repayment	Interest for monthly repayment	Monthly COF
1	2.698%	2.735%	\$ 81,244	\$ 185.20	\$ 2,359.76
2	2.710%	2.748%	\$ 81,618	\$ 186.88	\$ 2,174.56
3	2.723%	2.761%	\$ 81,994	\$ 188.64	\$ 1,987.68
4	2.740%	2.778%	\$ 82,371	\$ 190.69	\$ 1,799.04
5	2.759%	2.797%	\$ 82,751	\$ 192.90	\$ 1,608.35
6	2.781%	2.820%	\$ 83,132	\$ 195.33	\$ 1,415.45
7	2.801%	2.840%	\$ 83,514	\$ 197.64	\$ 1,220.11
8	2.822%	2.861%	\$ 83,899	\$ 200.04	\$ 1,022.47
9	2.851%	2.891%	\$ 84,285	\$ 203.03	\$ 822.43
10	2.870%	2.910%	\$ 84,673	\$ 205.32	\$ 619.40
11	2.871%	2.914%	\$ 85,063	\$ 206.56	\$ 414.08
12	2.871%	2.914%	\$ 85,455	\$ 207.51	\$ 207.51
			\$ 1,000,000		\$ 15,650.85

Interest Income	\$26,764
Interest Expense	\$15,651
Net Interest Income	\$11,113

Loan Profitability – Non-Interest Expense

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

Main Inputs:

- Annual Servicing Expense
- Percent of Average Balance - Servicing
- Percent of Amount - Servicing
- Annual Fees
- Equity Credit
- Average Capital
- Participation Fees and Expenses

Non-Interest Expense is:

- $[\text{Annual Servicing Expense}] + [\text{Percent of Average Balance} \times \text{Average Balance}] + [\text{Percent of Amount} \times \text{Amount}] + [\text{Percent of Net Interest Income} \times \text{Net Interest Income}] - [\text{Annual Fees}] - [\text{Equity Credit} \times \text{Average Capital}] - [\text{Participation Servicing Fees}] + [\text{Participation Servicing Expense}]$

In this Example:

- $\$2,076 + 0.0\% \times \$1,000,000 + 0.0\% \times \$1,000,000 - \$0 - \$0.0 \times \$88,665 - \$0 + \$0 = \$2,076$

Lines of Credit

- While the calculation of interest income is like that discussed in the previous slide, interest expense may differ for a line of credit.
- There are two components, the calculation for the funded portion and for the committed but unfunded portion.
- Typically a line of credit uses a floating rate type, as such a liquidity premium may be charged on the funded portion.
- Assume a \$1 million committed line that is 50% used for a 36-month term.

Interest Rate Swaps

Amount:	\$1,000,000
Indicative Fixed Rate:	5.21%
Payment Type:	Single Pay / Interest Only
Interest Options:	Actual/360 / Monthly
Maturity:	60 months
Rate Type:	Swap
Index:	Libor Auto: [Libor 1-Month : 2.451%]
Spread:	275 bps
Swap Information:	5Y / \$12,038 Estimated Fee

Forward Start Term:	None
Floating Rate to Bank (Libor 1-Month + 2.75%):	5.201%
5Y Swap vs Libor 1-Month + 2.75%:	4.96%
Swap Profit:	0.25%
Indicative Fixed Rate:	5.21%
Swap PV01:	\$482
Swap Fee:	\$12,038
Credit Equivalent Exposure:	\$0

Main Inputs:

- Rate Type – Swap
- Swap Floating Rate Index – Libor
- Spread – 275 basis points
- Swap Profit (Fee) – 25 basis points

Calculations:

- Based on Pricing Terms provided by a PL Swap provider (Chatham Financial, Derivative Path , Raymond James, etc.)
- In this example the Swap PV01 is \$482 per basis point
- The Indicative Fixed Rate in this example is 5.21% (the borrowers fixed rate), the bank would receive 1-month Libor plus 275 bps
- All profitability calculations are based on a floating rate at 1-month Libor plus 2.75%.

Loan Profitability – Multi-Factor Risk (1 of 7)

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662
Avg Regulatory Capital	\$80,000
Avg Economic Capital	\$71,943

Main Inputs:

- Borrower Risk Rating
- Average Balance
- Term Structure¹
- Type and Value of Collateral
- Type and Amount of Guarantees
- Minimum or Regulatory Capital Requirement

Loan Loss Reserve is:

- $[\text{Annual Loss (based on Risk Rating and Term)}] \times [\text{Adjusted Exposure at Default}^2]$

Average Economic Capital is:

- $([\text{Credit Capital (based on Risk Rating and Term)}] \times [\text{Adjusted Exposure at Default}^2] + [\text{Unmitigatable Capital}^3]) \times [\text{Average Balance}]$

1. Because the example is an Interest Only loan, there is a single repayment at the 60-month term. Term affects the duration of the exposure and you can vary Annual Loss and Credit Capital by duration.

2. Adjusted Exposure at Default is covered in the next slide.

3. Unmitigatable Capital is the total Operational & Market Risk Capital. It does not vary with Risk Rating or duration.

Loan Profitability – Multi-Factor Risk (3 of 7)

When using a multi-factor risk approach in PrecisionLender, the lender can specify the type(s) and amount(s) of guarantees. Each guarantee has a Recovery Factor defined that operates like the collateral Recovery Factor. In addition, each guarantee can have additional origination and servicing expenses associated with it. Finally, guarantees can either be risky guarantees (e.g. a personal or corporate guarantee) or considered riskless (such as a government guarantee). Riskless guarantees operate just like collateral except with additional expenses. Guarantees do not affect the Adjusted Exposure at Default, but instead affect how capital and annual loss are applied.

Guarantee Mitigation:

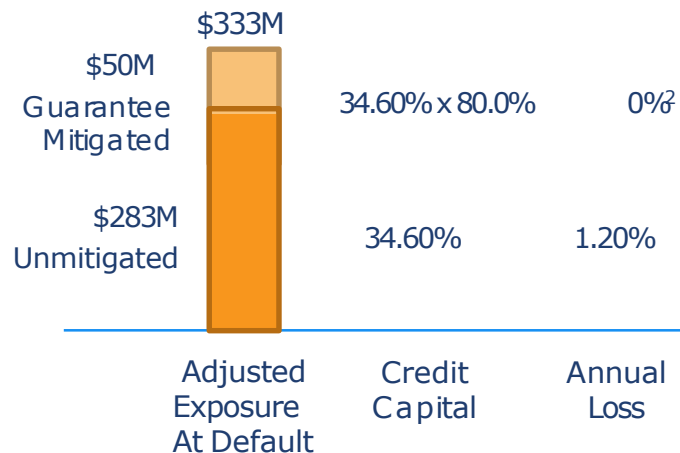
- \$1,000,000 Personal Guarantee
- Guarantor is a "4" Risk Rating and that Risk Rating has a 80.0% Guarantee Factor¹
- 5% Economic Recovery Rate
- Obligor is a "4" Risk Rating and has a Credit Capital rate of 34.6% (for a 60 month duration)
- = 5% x \$1,000,000 = \$50,000 of Guarantee mitigation

Loan Loss Reserves:

- [Unmitigated Exposure] x [Annual Loss]
- $\$283,333 \times 1.20\% + (50,000 \times 1.2\% \times 1.2\%) = \$3,407^3$

Average Equity (Capital) before time factor:

- [Guarantee Mitigated Exposure] x [Credit Capital Rate] x [Guarantee Factor]² + [Unmitigated Exposure] x [Credit Capital Rate]
- $\$50,000 \times 34.60\% \times 80.00\% + \$283,333 \times 34.60\% + \$1,000,000 \times 1.00\% = \$121,873^4$



1. Each Risk Rating has a Guarantee Factor as an assumption. This approach is taken from the Basel III approach to guarantees.
2. This factor is determined solely by the guarantor's Risk Rating and is then multiplied by the obligor's Credit Capital.
3. We assume obligor and facility loan loss percentage is the same.
4. This would be for the first month of the loan, there is a calculation for each month where the exposure value would decline with time particularly on amortizing loans.

Loan Profitability – Multi-Factor Risk (4 of 7)

The Credit Capital, Loan Loss and Guarantor factors change over time. This reflects the normal observation that loans of the same risk rating with a shorter term represent less overall risk than those of a longer duration.

- As part of the credit migration using Basel III analysis, the bank will determine the credit capital¹, loan loss and Guarantor factors based on different durations of a loan.
 - The table to the right shows that a loan with five years to maturity would have a credit capital rate of 34.60%. At one year this declines to 8.50%.
 - The three-year level would be 22.09%, is the interpolations between the one- and five-year durations.
 - The second table shows the change in credit capital over time and capital requirements.
1. The approach taken on the determination of the credit capital factor and annual loss is consistent with the **Basel III approach** as outlined in the International Convergence of Capital Measurement and Capital Standards (A Revised Framework Comprehensive Version).

Duration	Annual Loss	Credit Capital	Guarantor Factor
12	0.6%	8.5%	80.0%
60	1.2%	34.6%	80.0%
120	1.55%	48.3%	94.0%
For all	1.55%	48.3%	94.0%

Month	Exposure at Default	Guarantee Coverage	Guarantee Factor	Credit Capital	Credit Capital	Unmitigated	Total Economic Capital
1	\$333,333	\$50,000	80.00%	34.60%	\$111,873	\$10,000	\$121,873
2	\$333,333	\$50,000	80.00%	34.06%	\$110,115	\$10,000	\$120,115
3	\$333,333	\$50,000	80.00%	33.51%	\$108,357	\$10,000	\$118,357
4	\$333,333	\$50,000	80.00%	32.97%	\$106,599	\$10,000	\$116,599
5	\$333,333	\$50,000	80.00%	32.43%	\$104,841	\$10,000	\$114,841
6	\$333,333	\$50,000	80.00%	31.88%	\$103,083	\$10,000	\$113,083
24	\$333,333	\$50,000	80.00%	22.09%	\$71,436	\$10,000	\$81,436
25	\$333,333	\$50,000	80.00%	21.55%	\$69,678	\$10,000	\$79,678
26	\$333,333	\$50,000	80.00%	21.01%	\$67,920	\$10,000	\$77,920
27	\$333,333	\$50,000	80.00%	20.46%	\$66,162	\$10,000	\$76,162
40	\$333,333	\$50,000	80.00%	13.39%	\$43,306	\$10,000	\$53,306
41	\$333,333	\$50,000	80.00%	12.85%	\$41,548	\$10,000	\$51,548
42	\$333,333	\$50,000	80.00%	12.31%	\$39,790	\$10,000	\$49,790
43	\$333,333	\$50,000	80.00%	11.76%	\$38,032	\$10,000	\$48,032
60	\$333,333	\$50,000	80.00%	8.50%	\$27,483	\$10,000	\$37,483
average					\$61,943	\$10,000	\$71,943

Loan Profitability – PD-LGD Capital Risk (1 of 5)

The second method to determine capital and loan loss is the use of Probability of Default and Loss Given Default.

When using the PD-LGD risk approach (sometimes referred to as 2DRR) in PrecisionLender, the Relationship Manager (lender) specifies a risk rating (there is an associated PD set by the bank) and the LGD associated with the loan opportunity. There may be a facility category that can be selected that contains an associated LGD. The determination of the LGD is usually calculated in a separate system based on the amount and type of collateral and guarantees. If your institution uses the Multi-factor method, you can skip this section.

Loan Profitability – PD-LGD Capital Risk (3 of 5)

Non-Interest Expense	\$2,076
Loan Loss Reserves	\$1,998
Other Income	\$0
Pre-Tax Income	\$22,135
Taxes	\$4,648
Net Income	\$17,487
Average Balance	\$1,000,000
Average Equity	\$89,787
Avg Regulatory Capital	\$80,000
Avg Economic Capital	\$73,794

Loan Loss Reserve is:

- Average $\$1,000,000 \times .060\% \times 33.3\% = \$1,998$

Average Regulatory Capital:

- Discussion about Minimum or Regulatory capital can be found on slide 20, calculations are the same with either Economic Capital method used.
- Since this is an Interest Only Loan with an 8% minimum capital requirement the amount is $\$1,000,000 \times 8\% = \$80,000$

Loan Profitability – PD-LGD Capital Risk (4 of 5)

The Credit Capital and Loan Loss (PD) factors change over time. This reflects the normal observation that loans of the same risk rating with a shorter term represent less overall risk than those of a longer duration.

- As part of the credit migration using Basel III analysis, the bank will determine the credit capital¹ and loan loss based on different durations of a loan.
- The table to the right shows that a loan with five years to maturity would have a credit capital rate of 34.60%. At one year this declines to 8.50%.
- The three-year level would be 22.09%, is the interpolations between the one- and five-year durations.
- The second table shows the change in credit capital over time and capital requirements.

Duration	Annual Loss	Credit Capital
12	0.6%	8.5%
60	0.6%	34.6%
120	0.6%	48.3%

1. The approach taken on the determination of the credit capital factor and annual loss is consistent with the Basel III approach as outlined in the International Convergence of Capital Measurement and Capital Standards (A Revised Framework Comprehensive Version).

Months	Exposure at Default	Credit Capital	LGD	Credit Capital	Unmitigated and Other	Total Economic Capital	Minimum Capital	Required Capital
1	\$1,000,000	34.60%	33.3%	\$115,218	\$10,000	\$125,218	\$80,000	\$125,218
2	\$1,000,000	34.06%	33.3%	\$113,407	\$10,000	\$123,407	\$80,000	\$123,407
3	\$1,000,000	33.51%	33.3%	\$111,597	\$10,000	\$121,597	\$80,000	\$121,597
4	\$1,000,000	32.97%	33.3%	\$109,786	\$10,000	\$119,786	\$80,000	\$119,786
5	\$1,000,000	32.43%	33.3%	\$107,975	\$10,000	\$117,975	\$80,000	\$117,975
6	\$1,000,000	31.88%	33.3%	\$106,165	\$10,000	\$116,165	\$80,000	\$116,165
24	\$1,000,000	22.09%	33.3%	\$73,572	\$10,000	\$83,572	\$80,000	\$83,572
25	\$1,000,000	21.55%	33.3%	\$71,762	\$10,000	\$81,762	\$80,000	\$81,762
26	\$1,000,000	21.01%	33.3%	\$69,951	\$10,000	\$79,951	\$80,000	\$80,000
27	\$1,000,000	20.46%	33.3%	\$68,140	\$10,000	\$78,140	\$80,000	\$80,000
40	\$1,000,000	13.39%	33.3%	\$44,601	\$10,000	\$54,601	\$80,000	\$80,000
41	\$1,000,000	12.85%	33.3%	\$42,791	\$10,000	\$52,791	\$80,000	\$80,000
42	\$1,000,000	12.31%	33.3%	\$40,980	\$10,000	\$50,980	\$80,000	\$80,000
43	\$1,000,000	11.76%	33.3%	\$39,169	\$10,000	\$49,169	\$80,000	\$80,000
60	\$1,000,000	8.50%	33.3%	\$28,305	\$10,000	\$38,305	\$80,000	\$80,000
average						\$73,794	\$80,000	\$89,787

Loan Profitability – PD-LGD Capital Risk (5 of 5)

While calculation of capital is similar for a line of credit with other loan types, the method used to determine EAD is different.

- The EAD used in Economic Capital is the product of the Commitment Amount and the Average Usage Percentage plus the product of Unfunded amount (Commitment Amount times $1 - \text{Average usage Percentage}$) and the expected Usage Given Default percentage (UGD) for the risk rating associated with the loan . Note: the UGD can vary with the risk rating of the loan.
- In the determination of Regulatory capital the minimum capital rate is multiplied by the product of the Commitment Amount and the Average Usage Percentage plus the product of Unfunded amount and a credit conversion factor. This factor is 20% for lines with an original maturity of 12 months and less otherwise 50%. If the line of credit is cancellable by the bank (demand line) the credit conversion factor is 0%.

Loan Profitability – Taxes & Other

Interest Income	\$51,999
Interest Expense	\$25,980
Net Interest Income	\$26,019
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$21,545
Taxes	\$4,524
Net Income	\$17,021
Average Balance	\$1,000,000
Average Equity	\$88,662

Net Interest Income:

- $[\text{Interest Income}] - [\text{Interest Expense}]$

Other Income:

- Not used for loans (used for Other Fee-Based Products see next slide)

Pre-Tax Income:

- $[\text{Net Interest Income}] - [\text{Non Interest Expense}] - [\text{Loan Loss Reserves}] + [\text{Other Income}]$

Taxes:

- $[\text{Pre-Tax Income}] \times ([\text{State Tax Rate}] + [\text{Federal Tax Rate}] * \{1 - \text{State Tax Rate}\})$

Net Income:

- $[\text{Pre-Tax Income}] - [\text{Taxes}]$

Average Balance¹:

- The average monthly balance (average assets over the expected life) of the loan.

1. A complete month by month breakdown for all financial items can be found under the Advance Analytics area in the Amortization tab

Loan Profitability – Forward Rates

We use Implied Forward Rates as part of the match funding process whenever there is a guaranteed fixed rate on a future commitment.

Examples:

- A Construction loan that converts to Permanent Financing AND the rate on the Permanent Financing is Fixed and guaranteed at the closing of the Construction loan.
 - Example: a 12 month floating rate Construction loan that converts into a 60 month Commercial Real Estate loan with a guaranteed fixed rate. To match fund the CRE loan we “buy 72 month money” and “sell 12 month money”
- A fixed rate Construction or Land Development loan with draws scheduled in the future.

Note: we never use implied forward rates to attempt to predict rates in the future. We use them as a way to accurately match-fund and allocate Interest Expense.

Loan Profitability – Floating Rate with Floor

Raw Interest Income:	\$55,764
Origination Fees:	\$0
Origination Expenses:	(\$2,497)
Cap/Floor Impact:	\$8,846
Tax Exempt Impact:	\$0
Total:	\$62,113
Interest Income	\$62,113
Interest Expense	\$31,013
Net Interest Income	\$31,099
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$26,626
Taxes	\$5,591
Net Income	\$21,034
Average Balance	\$1,000,000
Average Equity	\$88,662

Example:

- \$1MM Commercial Real Estate Loan
- Interest Only
- Floating Rate at Prime (5.5%) plus 0.0% (Actual/360)
- Funding Cost is the shortest duration, typically one month (2.615%) adjusted to 365/360 plus Liquidity premium of 0.45%
- No Origination Fee
- Floor of 5.75%

Loan Profitability – Floating Rate with Floor

Raw Interest Income:	\$55,764
Origination Fees:	\$0
Origination Expenses:	(\$2,497)
Cap/Floor Impact:	\$8,846
Tax Exempt Impact:	\$0
Total:	\$62,113
Interest Income	\$62,113
Interest Expense	\$31,013
Net Interest Income	\$31,099
Non-Interest Expense	\$2,076
Loan Loss Reserves	\$2,398
Other Income	\$0
Pre-Tax Income	\$26,626
Taxes	\$5,591
Net Income	\$21,034
Average Balance	\$1,000,000
Average Equity	\$88,662

Interest Income is:

- [Initial Interest Rate] x
- [Adjustment for Interest Rate Basis] x
- [Average Balance] +
- [Origination Fees – Origination Expenses, Annualized over the Term] +
- Effect of the Floor ¹

1. Floor is 5.75% which is above the current rate of Prime at 5.50% plus 0.00%. The Floor is in effect for 60 months. Black 76 model is used to determine the value of that Floor based on relative volatility assumptions. Having a Floor will increase interest income while a Cap will reduce it. See the following Support article for further details: <https://support.precisionlender.com/hc/en-us/articles/206935767>

Overview – Deposit Profitability

- Interest Income
- Interest Expense
- Float and Reserves
- Capital

Deposit Profitability – Financial Statement

Interest Income	\$2,704
Interest Expense	\$1,000
Net Interest Income	\$1,704
Non-Interest Expense	\$690
Loan Loss Reserves	\$0
Other Income	\$0
Pre-Tax Income	\$1,014
Taxes	\$213
Net Income	\$801
Average Balance	\$100,000
Average Equity	\$2,000

Interest Income

- $(1 - [\text{Float \& Reserves}]) \times [\text{Average Balance}] \times [\text{Funding Curve TransferRate}]$
- [Funding Curve Transfer Rate] is based on the duration of the deposit. For non-maturity deposits this is a part of the Product definition. For Timed Deposits, this is set by the Term of the Timed Deposit.

Interest Expense

- $[\text{Average Balance}] \times [\text{Interest Rate Paid}]$

Non-Interest Expense

- $[\text{Average Annual Operating Expense}] - [\text{Average Annual Fee Income}]$

Average Balance

- The average monthly balance (average assets over the expected life) of the deposit.

Average Equity

- $[\text{Average Balance}] \times [\text{Deposit Capital Rate}]$

Specifically in this Example:

- Interest Income: $(1 - .18\%) \times \$100,000 \times 2.71\% = \$2,704$
- Interest Expense: $\$100,000 \times 1.00\% = \$1,000$
- Non-Interest Expense: $\$692 - \$2 = \$690$
- Average Equity: $\$100,000 \times 2.0\% = \$2,000$

Overview – Other Fee Profitability

- Interest Income
- Interest Expense
- Earning Credit

Fee Profitability – Product Types

- There are four fee types
 - Annual Revenue and Balance – Total average annual revenue is entered plus the expected average balance, example is wealth management
 - Annual Revenue – Only average annual revenue is entered, this amount is expected to be received over the life of the opportunity, costs of this service are entered in the Administration Section
 - Activity Based – Individual services where the average monthly expected volume is entered and the related unit revenue and unit cost are applied. Example is treasury management services
 - Expected One Time Revenue – For products where there is a one-time fee received, example is title insurance

Product Configurations & Defaults

Other Fee Type:

Target ROE:

Servicing Costs:

Annual Revenue

Annual Revenue and Balance

Annual Revenue

Activity Based

Expected One Time Revenue

Fee Profitability – Financial Statement

Description		Revenue	Balance	Net Income			
Cash Management	Lock Box and Other Treasury Management Service	\$11,067 /yr		\$4,387			
Monthly Unit Volume							
	Eligible for Earnings Credit	Estimated	Waived	Chargeable	Unit Price	Monthly Revenue	Monthly Expense
Lockbox Transactions	<input checked="" type="checkbox"/>	250	10	240	\$1.00	\$240.00	\$125.00
Wire Transfer	<input checked="" type="checkbox"/>	15	2	13	\$35.00	\$455.00	\$225.00
Debits	<input checked="" type="checkbox"/>	525	0	525	\$0.25	\$131.25	\$52.50
Lost Items	<input checked="" type="checkbox"/>	3	1	2	\$15.00	\$30.00	\$24.00
Deposits	<input checked="" type="checkbox"/>	22	0	22	\$3.00	\$66.00	\$33.00
Add							
Wealth Management	Third party referral fees	\$3,000 /yr	\$0				\$237

Other Income

- For Activity Based Fee Products, monthly unit volume by product type is needed.
- For Other Fee based products, estimated annual revenue is needed (see Wealth Management above).
- Note items stated as Eligible Revenue are those that earning credits can cover

Other Income Example

- $[\text{Unit Volume less Waived Units}] \times (\text{Unit Price less Unit Expense}) \times (1 - \text{tax rate})$
- Sum for each activity based item (if any)
- For non-activity based product = $\{[\text{Annual Revenue} \times (1 - \text{Expenses as a Percent of Revenue})] - \text{set dollar expense} \times (1 - \text{tax rate})\}$

Eligible Revenue:	\$11,067
Ineligible Revenue:	\$3,000
Gross Other Revenue:	\$14,067
Net Revenue:	\$14,067
Non-Interest Expense	
Loan Loss Reserves	
Other Income	
Servicing Expense:	(\$8,214)
Other Income:	\$5,853
	\$0
	\$5,853
	\$0
	\$5,853

Fee Profitability – Earning Credit – Financial Statement

Add Deposit ▾

	Rate	Balance	Net Income
DDA w/ TMS - Earnings Credit		\$250,000	\$3,580

Eligible Revenue:	\$11,067		
Ineligible Revenue:	\$3,000		
Gross Other Revenue:	\$14,067		
Applied Earnings Credit:	(\$1,875)		
Net Revenue:	\$12,192		
Servicing Expense:	(\$8,214)		
Other Income:	\$3,978		
Non-Interest Expense			
Loan Loss Reserves		\$0	
Other Income			\$3,978

Earnings Credit Deposit Type

- For Activity Based Fee Products, earning credits from a deposit can be used to compensate for fees
- In Deposit Assumption, earning credit rates can be listed


Earnings Credits ▾

	Balance	Rate
Up to \$50,000	Up to \$50,000	0.25%
Up to \$100,000	Up to \$100,000	0.5%
And over	And over	1.0%

Earnings Credit

- $[\text{First Balance}] \times (\text{First Balance Earnings Credit Rate}) + [\text{Second Balance}] \times (\text{Second Balance Earnings Credit Rate}) + \text{additional balances and credits}$
- $(\$50,000 \times 0.25\%) + (\$100,000 - \$50,000) \times 0.50\% + (\$250,000 - \$100,000) \times 1.00\% = \$1,875$

Fee Profitability – Financial Statement

Non-Interest Expense	\$0
Loan Loss Reserves	\$0
Other Income	\$8,515 
Pretax Income	\$8,515
Taxes	\$2,972
Net Income	\$5,543
Average Balance	\$0
Average Equity	\$0

Return on Equity – Putting it All Together


- Net Income
- Capital
- Return on Equity
- Return on Assets
- Target Return on Equity and Andi

Return on Equity

- Risk Adjusted Return on Capital (RAROC) or called within PrecisionLender, Return on Equity (ROE), is a ratio with the numerator being risk adjusted net income and the denominator being risk adjusted capital, or
- $ROE = \text{Net Income} / \text{Average Equity}$
- The ROE of a \$1 million 60-month amortizing loan with Net Income of \$16,730 and Average Equity of \$81,686 is $ROE = \$16,730 / \$81,686 = 20.48\%$

	CRE
Pre-Tax Income	\$21,178
Taxes	\$4,447
Net Income	\$16,730
Average Balance	\$923,587
Average Equity	\$81,686
ROE (RAROC)	20.48%

Opportunity Summary

Commercial Real Estate -... 20.48% 

Return on Assets

- Return on Assets (ROA), is a ratio with the numerator being risk adjusted net income and the denominator being average assets (Balances), or
- $ROA = \text{Net Income} / \text{Average Balance}$
- The ROA of a \$1 million 60-month amortizing loan with Net Income of \$16,730 and Average Equity of \$923,587 is $ROA = \$16,730 / \$923,587 = 1.81\%$

	CRE
Pre-Tax Income	\$21,178
Taxes	\$4,447
Net Income	\$16,730
Average Balance	\$923,587
Average Equity	\$81,686
ROA	<u>1.81%</u>

Opportunity Summary

Commercial Real Estate -... 1.81%



Return on Equity

- If the entire opportunity includes multiple loans, deposits and other fee sources, the opportunity ROE can be calculated similar to the ROE for the individual items weighted by their duration.
- The next example assumes 2 loans, a \$1 million 60-month loan (CRE)) and a \$500,000 36-month loan (C&I Install) also a \$100,000 deposit and a Wealth Management account (Other Fee).

	CRE	C&I Install	All Loans	Deposit	Other Fee	Total
Pre-Tax Income	\$21,178	\$3,446	\$23,245	\$966	\$253	\$24,464
Taxes	\$4,447	\$724	\$4,881	\$203	\$53	\$5,137
Net Income	\$16,730	\$2,722	\$18,364	\$763	\$200	\$19,326
Average Balance	\$923,587	\$263,261	\$1,081,544	\$100,000	\$0	\$1,181,544
Average Equity	\$81,686	\$18,428	\$92,743	\$2,000	\$0	\$94,743
ROE (RAROC)	20.48%	14.77%	19.80%	38.15%		20.40%


Return on Equity

- The Net Income for all loans is weighted by the term, since the C&I Install has a term 40% shorter than the CRE (36 months compared to 60 months), its net income is adjusted by a 60% factor.
- Total Loan Net Income = CRE Net Income + 60% C&I Install or $\$16,730 + 60\% * \$2,722 = \$18,364$. A similar calculation is used for Average Equity.
- The All Loan ROE = $\$18,364 / \$92,743 = 19.80\%$
- Deposits and most Other Fee products are assumed to last the entire term of the longest maturity loan (60 months in this example). Thus the total Net Income for the entire opportunity is: All Loans + Deposit + Other Fee = $\$18,364 + \$763 + \$200 = \$19,326$. A similar calculation is used for Average Equity (Note: Other Fee in this example has no Equity allocation, that is not always the case).
- The full Current Opportunity ROE is $\$19,326 / \$94,743 = 20.40\%$



Target Return on Equity and Andi

- The Bank will set a target ROE for all its loan, deposit and other fee products.
- Andi will provide suggestions on meeting ROE targets if the current loan or deposit is below the level set.
- Andi's ROE target suggestions (for example, increasing Initial Rate) are the result of a deterministic process that solves for the target return.



Here are ways to reach the target:

- Increase the Initial Rate by 45 bps
- Add \$3,659 to the Initial Fees
- Add 73 bps to the Initial Fees
- Increase Amortization to 107 months

Here are things to consider:

- Awesome job pricing deposits!

Engine Resources

PrecisionLender Engine Standards

The PrecisionLender Engine Standards provide a detailed specification of the underlying calculations used by the PrecisionLender Engine (the “Engine”). The document serves as the minimum functional description for testing and third-party auditing to ensure that the calculations used by the Engine are performed consistently and accurately. The engine standards are available on our support site at this link: <https://support.precisionlender.com/hc/en-us/articles/206935477-PrecisionLender-Engine-Standards>.

Managing Risks with PrecisionLender

Commercial pricing has moved beyond static, manual solutions. Banks need a solution that's easy to configure, adjust and monitor, helping them better manage risk. That's PrecisionLender. For more information, see this article: <https://support.precisionlender.com/hc/en-us/articles/4794971164947>.

NOTE: Access to the engine standards and attestation report is restricted. Access can be obtained by submitting a support request or sending an email to support@precisionlender.com.